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Deferred tax related to assets and liabilities arising from a single transaction (Proposed Amendments to IAS 12) Issues Paper

Objective

1 The purpose of this session is to seek early input from EFRAG TEG on the forthcoming proposed amendments to IAS 12 *Income Taxes* on deferred tax related to assets and liabilities arising from a single transaction (the forthcoming amendments). An exposure draft on the forthcoming amendments is expected in June 2019.

Background

2 In 2018, the IFRS Interpretations Committee (IFRS IC) received a submission regarding the recognition of deferred tax when a lessee initially recognises a lease asset and lease liability under IAS 17 *Leases*. A similar question arises when an entity recognises a decommissioning liability under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and a corresponding item of property, plant and equipment (PPE) under IAS 16 *Property, Plant and Equipment.*

3 The entity's lease payments and decommissioning costs are deductible for tax purposes on a cash basis. The submitter noted that this question will arise more often when entities apply IFRS 16 *Leases* than when applying IAS 17 *Leases*.

4 The submitter assumed that the initial recognition of the leased asset and the leased liability gives rise to a taxable temporary difference in relation to the asset and a deductible temporary difference in relation to the liability.[1] The submitter asked whether the initial recognition exemption in IAS 12 would apply to those temporary differences. The submitter identified three different approaches in practice, which are:

(a) *Approach 1 - the initial recognition exemption applies.*

An entity applies the initial recognition exemption separately to the asset and liability and, accordingly, does not recognise any deferred tax asset or liability.

(b) *Approach 2 - the asset and liability are 'integrally linked' and no temporary difference arises on initial recognition.*

An entity assesses the asset and liability together on a net basis (i.e. as a single unit of account). On initial recognition, the net carrying amount and the

[1] A similar scenario would apply when the entity recognises a decommissioning liability and the counterpart entry as an asset, and the liability is tax deductible on a cash basis.

net tax base of the asset and liability assessed together are both equal to nil. Thus, temporary differences do not arise on initial recognition and the initial recognition exemption is not applicable.

(c) *Approach 3 - the initial recognition exemption does not apply to the gross temporary differences.*

The initial recognition exemption is assumed to apply only when an entity recognises an asset or liability. Thus, the initial recognition exemption does not apply on initial recognition of the asset and liability because an entity recognises both at the same time. An entity therefore recognises a deferred tax asset or liability for each gross temporary difference when it recognises the related asset and liability.

5 The IFRS IC discussed the submission at its meetings in March and June 2018. It observed that, in some situations, offsetting (equal) temporary differences arise on initial recognition of assets and liabilities related to leases or decommissioning obligations. The question is whether an entity (i) recognises deferred taxes for these temporary differences, or (ii) applies the initial recognition exemption in IAS 12.

6 The IFRS IC observed that the issue is widespread and that as noted in paragraph 4 above, entities apply different reporting methods, both within and across jurisdictions. The different practices can lead to material differences between the financial statements of entities with leases or decommissioning obligations.

7 The IFRS IC decided to recommend that the IASB propose an amendment to IAS 12 that would narrow the applicability of the initial recognition exemption so that it would not apply to temporary differences of the same amount in cases such as leases and decommissioning obligations.

What is the purpose of the initial recognition exemption?

8 As a general principle, IAS 12 requires an entity to recognise deferred taxes for all temporary differences. However, paragraphs 15 and 24 of IAS 12 prohibit entities from recognising deferred tax assets or liabilities—both at initial recognition and subsequently—for deductible or taxable temporary differences arising from the initial recognition of an asset or liability in a transaction that (a) is not a business combination, and (b) at the time of the transaction, affects neither accounting profit nor taxable profit (initial recognition exemption).

9 Paragraph 22(c) of IAS 12 provides the basis for the initial recognition exemption, as follows:

> '… if the transaction is not a business combination, and affects neither accounting profit nor taxable profit, an entity would, in the absence of the exemption provided by paragraphs 15 and 24, recognise the resulting deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount. Such adjustments would make the financial statements less transparent. Therefore, this Standard does not permit an entity to recognise the resulting deferred tax liability or asset, either on initial recognition or subsequently. Furthermore, an entity does not recognise subsequent changes in the unrecognised deferred tax liability or asset as the asset is depreciated.'

10 This paragraph clarifies that the purpose of the initial recognition exemption is to avoid the adjustment to the carrying amount of an asset or liability that would be necessary if an entity were to recognise a deferred tax asset or liability. That adjustment would make the financial statements less transparent. It would also be inappropriate to recognise it as a gain or loss in profit or loss, given that the transaction itself has no effect on accounting profit or loss (or taxable profit or loss).

11 However, in cases such as the one being addressed by the forthcoming amendments, it might be less clear when to apply the initial recognition exemption.

The forthcoming proposed amendments to IAS 12

12 The IASB discussed the recommendation of the IFRS IC at its meeting in October 2018 and in January 2019.

Application of the initial recognition exemption

13 The forthcoming amendments would narrow the applicability of the initial recognition exemption in paragraphs 15 and 24 of IAS 12 so that it **would not apply** to temporary differences of the same amount in cases such as leases and decommissioning obligations. The IASB observed that in such cases the recognition of a deferred tax asset and a liability would generally be of the same amount and thus there is no need for the initial recognition exception.

14 The IASB also observed that, for leases and decommissioning obligations, temporary differences would generally relate to the same taxation authority and taxable entity. Therefore, it is possible that an entity would meet the recoverability requirement for recognition of a deferred tax asset solely through the future reversal of the taxable temporary difference arising from the same transaction. However, this would not be the case to the extent the temporary differences reverse in different periods and the tax law disallows the carry forward or carry back of tax losses. Consequently, any deferred tax assets would be recognised only to the extent the entity would recognise a deferred tax asset considering the recoverability requirement.

15 When assessed independently of other sources of profit, it is more likely that an entity would be unable to recognise some portion of a deferred tax asset related to decommissioning obligations than to leases. This is because the pattern of reversal of taxable and deductible temporary differences might often be similar in the case of leases—lease payments are often made throughout the lease term as the lease asset is being depreciated. This may not be the case for decommissioning obligations, which are typically settled towards the end of the useful life of the related asset.

16 Consequently, the IASB decided that the initial recognition exemption should continue to apply to any portion of the deferred tax liability for which an entity does not recognise a corresponding deferred tax asset. This is because, if an entity were to recognise any such excess deferred tax liability, the entity would have to recognise the other side of the entry either as an adjustment to the carrying amount of the related asset or liability, or as a gain or loss in profit or loss. Therefore, recognising this portion of the deferred tax liability would result in the outcome that the initial recognition exemption was designed to prevent (see paragraph 9).

17 In the view of the IASB, the forthcoming amendments would not only reduce the potential for material differences between the financial statements of entities, but also result in more useful information for users of financial statements and align the accounting for the tax effects of those transactions with the general principle in IAS 12 for deferred tax.

Transition requirements

18 Regarding transition, the IASB tentatively decided that:

(a) To require entities to apply the proposed amendments retrospectively applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, entities would be permitted to assess whether the requirements in IAS 12 to recognise deferred tax assets are met only at the date of transition (transition relief).

(b) To provide transition relief to first-time adopters, i.e. first-time adopters would be permitted to assess whether the requirements in IAS 12 to recognise deferred tax assets are met only at the date of transition to IFRSs.

(c) To permit earlier application of the proposed amendments.

IASB staff analysis

Application of the initial recognition exemption in IAS 12

19 On initial recognition of a lease[2], an entity needs to determine the tax base of the asset and liability and whether temporary differences arise in determining whether to recognise deferred tax applying IAS 12.

20 An entity determines the tax bases of the right-of-use asset (lease asset) and lease liability by identifying the amounts attributable to them for tax purposes. Based on the applicable tax law, an entity determines whether tax deductions for lease payments are attributable to:

(a) the lease asset (and interest expense)—because the deductions relate to the expenses arising from the lease (i.e. depreciation and interest expense); or

(b) the lease liability (and interest expense)—because the deductions relate to the repayment of the lease liability and interest expense.

21 As explained in the analysis below, depending on how tax deductions are attributed (to the lease asset or the lease liability) might or might not create temporary differences, which determines the application of the initial recognition exemption.

Tax deductions are attributable to the lease asset

22 When an entity attributes the tax deductions to the lease asset and future interest accrual at lease commencement:

(a) Under paragraph 7 of IAS 12, the tax base of the asset equals its carrying amount. This is because the carrying amount will be fully deductible for tax purposes in future periods.

(b) Under paragraph 8 of IAS 12 the tax base of the liability also equals its carrying amount. This is because the carrying amount will not be deductible for tax purposes in future periods. Tax deductions will be available for interest that the entity has not yet accrued at lease commencement. Tax deductions will be available in each of the 5 years of the lease when the entity accrues interest on the lease liability.

23 Accordingly, when tax deductions are attributed to the lease asset, **temporary differences do not arise on initial recognition** of the lease asset and lease liability **and thus the initial recognition exception is not applicable**.

24 At the commencement of the lease, an entity does not recognise any deferred tax at lease commencement given that there are no temporary differences. However, in subsequent periods, temporary differences will arise when the tax deductions obtained by the entity in each reporting period on a cash basis will not equal the total expense recognised by the entity in profit or loss. Because the entity does not apply the initial recognition exemption in this situation, it recognises a deferred tax asset and deferred tax income under IAS 12 as these temporary differences arise in subsequent periods.

[2] The analysis applies equally to decommissioning assets and liabilities. In addition, it is assumed that the transaction or event that gives rise to the lease asset and lease liability is not a business combination.

25 In line with the objective of IAS 12, the effect of recognising deferred tax income—and, later, a deferred tax expense when the temporary differences unwind—is that of recognising the tax benefit of the transaction, which arise in the form of tax deductions, in line with (a) the pattern of recovery of the asset through depreciation; and (b) the accrual of interest over the lease liability.

26 Appendix 1 illustrates the tax effects of tax deductions attributable to the lease asset.

Tax deductions are attributable to the lease liability

27 Depending on the provisions of the applicable tax law, an entity might attribute the tax deductions to the repayment of the principal amount of the lease liability and the future interest accrual. In this case, the tax base of the liability is zero because its carrying amount will be fully deductible for tax purposes in future periods.

28 Consequently, **a temporary difference arises on initial recognition** of the lease liability. Because the entity attributes no tax deductions to the lease asset, its tax base is zero. Accordingly, a temporary difference also arises on the lease asset.

29 The IASB staff concluded that, when tax deductions are attributable to the lease liability, an entity **would apply the initial recognition exemption**, and would not recognise a deferred tax asset or liability on initial recognition of the lease asset and lease liability.

30 Furthermore, when the initial recognition exemption applies, paragraph 22(c) of IAS 12 does not permit an entity to recognise subsequent changes in the unrecognised deferred tax asset or liability. Accordingly, the entity does not recognise deferred tax as it depreciates the lease asset or settles the lease liability. This results in the financial statements of a lessee reflecting the tax effects of the lease in profit or loss as the tax deductions become available for tax purposes (on a cash basis), rather than as the entity recovers (or settles) the associated lease asset and lease liability for accounting purposes. This would result in a difference between the effective tax rate and the applicable tax rate for the transaction.

31 Appendix 1 illustrates the tax effects of tax deductions attributable to the lease liability.

IASB staff analysis of the approaches in paragraph 4 of this paper

32 As explained in paragraphs 20 and 21, an entity would first need to determine whether tax deductions for lease payments are attributable to (i) the lease asset or (ii) the lease liability. This analysis was supported by the IFRS IC and the IASB.

33 The application of the initial recognition exemption would depend on whether or not temporary differences arise on initial recognition. As explained in paragraphs 23 to 30, this will depend on whether an entity attributes the future tax deductions to the lease asset or lease liability, even though the net temporary difference arising from the transaction is the same in either case. When tax deductions are attributed to the lease asset, temporary differences do not arise on initial recognition of the lease and the initial recognition exception is not applicable. However, when tax deductions are attributed to the lease liability, temporary differences will arise and the initial recognition exemption applies. This would be the outcome in Approach 1 in paragraph 4(a); but only when tax deductions are attributed to the lease liability. The outcome would depend on how the tax deductions are attributed.

34 The IASB staff noted that when applying Approach 2 in paragraph 4(b) of this paper, an entity assesses the lease asset and lease liability together as a single transaction because they are 'integrally linked'. Proponents of Approach 2 say this is consistent with the way in which the lease transaction is viewed for tax purposes. Although the IASB staff agree that, for tax purposes, the tax authority considers the lease transaction to be a single item on which it gives a single set of tax deductions, the

IASB staff think there is no basis for this approach in IAS 12. This is because they think the requirements in IAS 12 apply separately to assets and liabilities recognised for accounting purposes.

35 Under Approach 3 in paragraph 4(c) the initial recognition exemption in IAS 12 applies only when an entity recognises an asset **or** a liability. In the case of leases, an entity recognises an asset **and** a liability at lease commencement, proponents of this approach say the conditions underlying the initial recognition exemption are not present. An entity therefore recognises a deferred tax asset and deferred tax liability for the temporary differences that arise on initial recognition of the lease asset and lease liability on a gross basis. The IASB staff do not support this view. They argue that 'or' within the phrase 'initial recognition of an asset or liability' in paragraphs 15 and 24 of IAS 12 merely means that the condition applies equally to assets and liabilities recognised for accounting purposes. It does not mean that in the single transaction an entity must recognise only an asset or a liability for the condition to apply.

36 In conclusion, the IASB staff analysis observed that none of the Approaches in paragraph 4 provide the right solution, and an amendment, rather than an interpretation, to IAS 12 is needed.

Standard-setting possibilities

37 When discussing how to address the issue, the IFRIC IC considered whether to:

(a) recommend that the IASB propose an amendment to IAS 12 that would narrow the scope of the initial recognition exemption so that it would not apply to a transaction that gives rise to both an asset and liability on initial recognition. This approach would result in entities recognising deferred tax assets and liabilities for temporary differences arising from the initial recognition of a lease; or

(b) develop an interpretation that would explain how an entity applies the requirements in IAS 12 without changing the scope of the initial recognition exemption. This approach could result in an entity not recognising deferred tax assets or liabilities on initial recognition of a lease when tax deductions relate to the lease liability.

38 The IFRS IC observed that developing an interpretation could reduce differences in the accounting for similar transactions. However, this option would retain an accounting outcome that is not aligned with the general principle in IAS 12. This is because the initial recognition exemption would continue to apply in situations in which it is not needed (i.e. when tax deductions are attributable to lease liability). Therefore they recommended a narrow-scope amendment to IAS 12.

Other considerations

39 The IASB considered the following additional aspects:

(a) *Advance lease payments and initial direct costs* - The IASB observed that making advance lease payments or incurring initial direct costs could result in additional amounts of taxable temporary differences associated with the lease asset. The initial recognition exemption would not apply to temporary differences arising from the recognition of advance lease payments or initial direct costs because these payments affect taxable profit (tax loss). An entity would recognise deferred taxes for any temporary differences arising from such payments under IAS 12. Therefore, advance lease payments and initial direct costs do not affect the forthcoming amendments.

(b) *Ability to recognise deferred tax assets and reassessment of unrecognised deferred tax assets* – As explained in paragraph 14, the forthcoming amendments would require an entity to recognise a deferred tax liability only to the extent that it would recognise a deferred tax asset considering the recoverability requirement.

EFRAG Secretariat preliminary analysis and recommendation

40 The EFRAG Secretariat notes that the issue being addressed in the forthcoming amendments is not new and diversity in practice has existed for some time. However, as explained in the submission to the IFRS IC, the issue has probably become more significant with the introduction of IFRS 16 with more lease assets and liabilities being recognised.

41 The EFRAG Secretariat agrees that the issue should be addressed through an amendment to IAS 12. We also agree with the forthcoming amendments and the underlying reasoning, as summarised in paragraphs 13 to 16 and the transition requirements in paragraph 18.

42 In our view, using a lease as an example, the deferred tax principle should be the same regardless of whether the tax deductions are attributable to the lease asset or lease liability. Currently this is not the case, because under IAS 12, the initial recognition exemption would depend on the attribution of the tax deductions and/or whether the lease asset and liability are considered ‘integrally linked’. The forthcoming amendments will only permit the application of the initial recognition exemption when it is needed for its intended purpose – when the temporary differences at initial recognition are of unequal amounts (resulting in an unequal deferred tax asset and deferred liability on initial recognition). The forthcoming amendments will bring consistency in the accounting for deferred tax for economically similar situations.

43 We have reviewed the practices recommended by the large audit firms in their respective accounting manuals (see Appendix 2 for a summary). A common practice is Approach 2 in paragraph 4(b). Although the reasoning of the IASB supporting the forthcoming amendments differs from Approach 2, the outcomes will be similar when temporary differences arising from the asset and liability are of equal amounts; in both cases the initial recognition exception would not apply.

44 The EFRAG Secretariat notes that the forthcoming amendments focus on the lessee (in the case of a lease) and do not address the deferred tax consequences for the lessor. We note that lessor accounting is unchanged and we have not identified diversity in practice for lessors.

Questions for EFRAG TEG members

45 Do you agree with the forthcoming amendments and the underlying reasoning supporting the amendments as outlined in paragraphs 13 to 17? If not please explain why and what alternatives you would suggest.

46 Do you agree with the EFRAG Secretariat analysis in paragraphs 40 to 44 as a basis for developing an initial EFRAG response to the forthcoming amendments?

47 Do you agree with the transition requirements for the forthcoming proposed amendments as outlined in paragraph 18?

48 Do you have any other comments on the forthcoming amendments?

Appendix 1: Examples

The examples below have been copied from agenda paper 12B discussed at the IASB meeting in October 2018 link.

Fact pattern

1 Lessee rents a building for five years. The lease payments are CU1006 per year, payable at the end of each year. Lessee's incremental borrowing rate is 5%. Lessee calculates the present value of the lease payments on initial recognition of the lease asset and lease liability as CU435. The lease payments are deductible for tax purposes on a cash basis. The tax rate is 20%.

Tax deductions are attributable to the lease asset

2 The table below shows the carrying amount of the lease asset and lease liability over the 5-year lease term:

Lease liability CU

	Opening carrying amount	Interest accrued	Payments	Closing carrying amount
Year 1	435	22	(100)	357
Year 2	357	17	(100)	274
Year 3	274	13	(100)	187
Year 4	187	9	(100)	96
Year 5	96	4	(100)	-
Total		**65**	**(500)**	

Lease asset CU

	Opening carrying amount	Depreciation[7]	Closing carrying amount
Year 1	435	(87)	348
Year 2	348	(87)	261
Year 3	261	(87)	174
Year 4	174	(87)	87
Year 5	87	(87)	-
Total		**(435)**	

3 The tables above illustrate that the entity recognises total lease payments of CU500 in profit or loss over the 5-year period as depreciation of CU435 and interest expense of CU65. The tax deductions of CU500 relate to depreciation (CU435) and interest expense (CU65) and, thus, the tax base of the lease asset equals its carrying amount (CU435) on initial recognition. **Accordingly, a temporary difference does not arise on initial recognition of the lease asset.**

4 In subsequent periods, the entity will recognise deferred tax as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
Depreciation	87	87	87	87	87
Interest expense	22	17	13	9	4
Total in P&L	**109**	**104**	**100**	**96**	**91**
Tax deduction	100	100	100	100	100
Temporary difference	9	4	-	(4)	(9)
Deferred tax income / (expense) (@20%)	**1.8**	**0.8**	**-**	**(0.8)**	**(1.8)**
Carrying amount of deferred tax asset recognised at the end of the year	**1.8**	**2.6**	**2.6**	**1.8**	**-**

5 The following table illustrates the current tax expense calculation using the same example, but also assuming the entity recognises revenue of CU120 in each of the periods:

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	120	120	120	120	120
Tax deduction	(100)	(100)	(100)	(100)	(100)
Taxable profit	20	20	20	20	20
Current tax expense (@20%)	**4**	**4**	**4**	**4**	**4**

6 The following table illustrates the entity's statement of profit or loss during the 5-year lease term. The table shows that **recognising and unwinding deferred tax results in the entity allocating the tax effects of the transaction in line with how the recovery of the lease asset and settlement of the lease liability affect profit or loss** (i.e. depreciation and interest relating to the lease).

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Revenue	120	120	120	120	120
Depreciation expense	(87)	(87)	(87)	(87)	(87)
Interest expense	(22)	(17)	(13)	(9)	(4)
Profit before tax	*11*	*16*	*20*	*24*	*29*
Current tax expense	4	4	4	4	4
Deferred tax expense/(income)	(1.8)	(0.8)	-	0.8	1.8
Tax expense	*2.2*	*3.2*	*4.0*	*4.8*	*5.8*
Profit after tax	*8.8*	*12.8*	*16.0*	*19.2*	*23.2*
Effective tax rate (Tax expense / Profit before tax)	**20%**	**20%**	**20%**	**20%**	**20%**

Tax deductions are attributable to the lease liability

7 The table below shows the temporary differences arising on initial recognition and over the 5-year lease term on both the lease asset and lease liability, for which the entity does not recognise deferred tax. It shows that the net unrecognised deferred tax asset is equal, in each period, to the deferred tax asset recognised in the previous situation.

	Lease asset		
	Carrying amount	**Tax base**	**Taxable temporary difference**
Initial recognition	435	-	435
Year 1	348	-	348
Year 2	261	-	261
Year 3	174	-	174
Year 4	87	-	87
Year 5	-	-	-

	Lease liability		
	Carrying amount	**Tax base**	**Deductible temporary difference**
Initial recognition	435	-	435
Year 1	357	-	357
Year 2	274	-	274
Year 3	187	-	187
Year 4	96	-	96
Year 5	-	-	-

Appendix 2: Accounting practices recommended by the large accounting and audit firms

Introduction

1 This appendix summarises the approaches noted by large accountancy networks to be followed by entities in respect of the deferred tax accounting for leases and decommissioning costs by entities.

2 It should be noted that if IFRS 16 is not yet adopted by an entity, similar considerations apply under IAS 17 but only for finance leases.

PricewaterhouseCoopers

Leases

Lessee

3 Two principal approaches are noted in respect of the deferred tax accounting for lessees:

(a) The lease is considered as a single transaction in which the asset and liability are integrally linked – hence there is no temporary difference at inception. Subsequently, as differences arise on settlement of the liability and the amortisation of the leased asset, there will be a net temporary difference on which deferred tax should be recognised.

(b) The asset and liability are considered separately:

(i) Applying the initial recognition exemption (IRE), the temporary difference on each item (difference between the carrying amount and a tax base of nil) does not give rise to deferred tax.

(ii) There is second view that IRE does not apply. An asset and a liability are recognised at the same time, with equal and opposite temporary differences. This effectively leads to the same result as the first approach, but disclosures are different as both the deferred tax asset and the deferred tax liability should be disclosed at their gross amounts.

Subsequent accounting will depend on the relevant approach as explained above.

4 The choice of approach is a matter of accounting policy, to be applied on a consistent basis.

Lessor

5 A lessor should consider the de-recognition of the leased asset and the recognition of the finance lease receivable as a single linked transaction. As such, there is no temporary difference and IRE is not applicable

6 At inception, the tax base of the leased asset might be equal to or different from the carrying amount of the lease receivable. Deferred tax is recognised to the extent that there is a temporary difference. Subsequently, deferred tax should be recognised, corresponding to the temporary difference that will change or arise.

Decommissioning costs

7 Two principal approaches are noted for the deferred tax accounting for decommissioning:

(a) The decommissioning assets and liabilities are integrally linked and should be viewed on a net basis. No deferred tax arises on inception.

Subsequently, deferred tax would be recognised on the temporary difference arising, on account of depreciation and the unwinding of the discount.

(b) Future tax deductions are allocated to the liability. The tax base for both asset and liability is nil. There are temporary differences equal to the carrying amount of the asset and the liability on initial recognition.

(i) IRE may apply for decommissioning obligations and related assets, in which case no deferred tax arises on initial recognition.

(ii) There is an additional view that IRE does not apply under the second approach. An asset and a liability are recognised at the same time, with equal and opposite temporary differences. This effectively leads to the same result as the first approach at initial recognition, but disclosures are different as both the deferred tax asset and the deferred tax liability should be disclosed at their gross amounts.

Subsequent accounting will depend on the relevant approach as explained above.

8 The choice of approach is a matter of accounting policy to be consistently applied.

KPMG

Leases

Lessee

9 The asset and liability that arise for accounting purposes under a finance lease are integrally linked, hence they should be regarded as a net package for the purposes of recognising deferred tax. The view of KPMG is that that the application of the initial recognition exemption is not appropriate.

10 On initial recognition, the taxable temporary difference arising on the asset is equal to the deductible temporary difference on the liability, resulting in a net temporary difference of zero. There is therefore no deferred tax to be recognised, and the IRE does not apply.

11 Subsequently, net taxable temporary differences may arise, for which deferred tax should be recognised.

Lessor

12 The lessor derecognises the leased asset and recognises a receivable amount equal to the net investment in the lease. As is the case for the lessee, the finance lease asset and the tax deductions that arise on the leased asset are integrally linked, hence they should be considered together for the purpose of recognising deferred tax.

13 The position on IRE is the same as for the lessee.

Decommissioning costs

14 The asset and liability that arise for a decommissioning provision are integrally linked, hence they should be regarded as a net package for the purposes of recognising deferred tax.

15 On initial recognition, the net temporary difference arising is zero. As a result, no deferred tax is recognised, and IRE does not apply.

16 Subsequently, net taxable temporary differences may arise, for which deferred tax should be recognised.

Deloitte

Leases

Lessee

17 When the asset is recognised initially, if the tax base ascribed to it is different from its carrying amount, a temporary difference arises, but <u>no deferred tax is recognised due to the application of IRE</u>.

18 In subsequent periods, as the asset is depreciated, new deductible or taxable temporary differences may arise for which deferred tax may be recognised. The lease liability is likely to have a tax base equal to its carrying amount because deductions are given in future for the finance cost portion of the lease payment, which is not reflected in the carrying amount of the lease liability at inception.

19 <u>When tax deductions are received for lease payments as they are paid</u> (and not for depreciation or finance costs), there are two acceptable approaches to accounting for the deferred tax consequences:

(a) Approach 1 -The <u>asset and lease liability are considered separately</u>: The asset has a tax base of zero and the lease liability also has a tax base of zero because the lease payments are deductible in the future. This gives rise to a temporary difference on initial recognition of both the asset and the liability, that is not recognised due to the application of IRE. Subsequently, the temporary differences decrease as the asset is depreciated and the liability is repaid. No deferred tax is recognised on either the asset or the liability due to the continued application of IRE (assuming no new temporary differences arise). Therefore, this approach may result in no deferred tax recognised either initially or over the term of the lease.

(b) Approach 2 - The <u>asset and lease liability are considered as linked</u>: at inception of the lease there is no net asset or liability, no tax base, and therefore no temporary difference. Subsequently, as depreciation on the asset (generally straight-line) initially exceeds the rate at which the debt reduces, a net liability arises resulting in a deductible temporary difference on which a deferred tax asset should be recognised if recoverable.

Decommissioning costs

20 There are two acceptable approaches:

(a) Apply the requirements in the normal way to a <u>separate asset and liability</u>.

(b) <u>View the asset and its decommissioning liability together</u>.

EY

21 Three alternative approaches are seen in practice:

(a) <u>Apply the IRE</u>: Recognise nothing in respect of temporary differences arising at the time the asset and liability are first recognised. No deferred tax arises for any changes in those initial temporary differences.

(b) <u>Consider the asset and the liability separately</u>: Recognise a deferred tax liability for any taxable temporary differences related to the asset component and a deferred tax asset for any deductible temporary differences related to the liability component. On initial recognition, the taxable temporary difference and the deductible one are equal and offset to zero. Deferred tax is recognised on subsequent changes to the taxable and deductible temporary differences.

(c) <u>Regard the asset and the liability as in-substance linked to each other</u>: Consider any temporary differences on a net basis and recognise deferred tax on that net amount. On this basis, the net carrying value of the asset and liability is zero on initial recognition, as is the tax base. There is therefore no temporary difference and IRE does not apply. Deferred tax is recognised on subsequent temporary differences that arise when the net asset or liability changes to zero.

Leases

22 By application of IRE separately to the recognition of the leased asset and the lease liability, the first approach above is used. The accretion of interest on the lease liability does create a deductible temporary difference, creating variability in the effective tax rate in the income statement.

23 Alternatively, by disregarding IRE and considering the asset and liability recognised at the inception of the lease as a single transaction, either the second or the third approach above can be used. In both these approaches, the fact that the leased asset is amortised at a different rate to the underlying finance lease liability does not result in the effective tax rate in the income statement.

Decommissioning costs

24 All the above approaches are acceptable in practice for decommissioning costs.

Conclusion

25 Three approaches are used for deferred tax accounting by lessees as follows:

(a) The asset and the liability are considered separately and IRE is applied – the temporary difference on each item does not give rise to deferred tax.

(b) The asset and the liability are considered separately without applying the IRE – the asset and liability are recognised at the same time, and the associated deferred tax asset and deferred tax liability are disclosed at their gross amounts.

(c) The asset and the liability are considered as integrally linked to each other – no temporary difference arises on initial recognition, therefore IRE does not apply.

26 No deferred tax accounting diversity is identified for lessors.

27 The approaches used for decommissioning costs are the same as those used for lessees.